SECRET

10 April 1987

MEMORANDUM FOR: Distribution

SUBJECT: Inter-Agency Meeting

Bob: book in EPC file! gr

TYPE OF MEETING	EPC/DPC (DPC circled)
DATE	Tuesday, 14 April 1987
TIME	1100
PLACE	Roosevelt Room
CHAIRED BY	Baker
ATTENDEE(S) (probable)	ADCI
SUBJECT/AGENDA	Energy Security
PAPERS EXPECTED	By Monday, 13 April
INFO RECEIVED	Per Cabinet Affairs, 1600

DISTRIBUTION:

25X1

DCI
DDCI
ExDir
DDO
DDI
Ch/NIC
✓ D/Exec Staff
ES
SDO/CPAS
ER

Mr. Tate to attend — CA notif'd 4/10

SECRET

SECRET

25X1

The Director of Central Intelligence

Washington, D.C. 20505

National Intelligence Council

NIC 01624-87
10 April 1987

MEMORANDUM FOR: Acting Director of Central Intelligence

FROM: Deane E. Hoffmann
National Intelligence Officer for Economics

SUBJECT: 14 April Joint EPC/DPC on Energy Security

1. Action. Deputy Secretary Martin told me he would like you to speak on the security aspects of reliance on Persian Gulf oil at the EPC/DPC. He plans to call you to give more detail on how he would like the security presentation to fit the overall meeting. Talking points on energy security and some background on the published, unclassified energy security study are attached.

2. The key point is that, while we take for granted that the Persian Gulf is a hot spot, we also take for granted the existence of moderate, friendly Arab regimes on the Arabian Peninsula. We can't forecast a violent turnover as a probability over the next 10 to 12 years, but we must remember that conditions are ripe for problems and that the result could be as detrimental to our interests in many ways as the fallout from the Iranian revolution.

3. Background. Roughly a year ago the President tasked the Department of Energy to prepare a study on energy security and policy recommendations. Bill Martin took charge of the effort and played the role of lead analyst. At his request, OGI participated in the study and provided much of the analysis relating to future reliance on oil. The bottom line of the study is that our reliance on Persian Gulf oil will increase in the 1990's; the rate of increase will depend largely on prices between now and then. The lower the path of oil prices, the greater the reliance on Gulf oil in the 1990s.

4. The unclassified study was discussed at an EPC/DPC meeting on 20 March. The EPC/DPC was in general agreement that:

-- A better definition of energy security as it relates to the policy alternatives was needed (this was provided by OGI, Tab C);

CL BY SIGNER
DECL OADR

SECRET

25X1

SUBJECT: 14 April Joint EPC/DPC Meeting on Energy Security

-- Import tariffs and domestic energy taxes aimed at reducing reliance on foreign oil are too expensive;

-- A more rapid rate of additions to the strategic petroleum reserve (SPRO) is the most viable option; and

-- There should be some sort of assistance to the domestic industry to improve domestic production.

Options are constrained by two key factors--they must (a) be "revenue neutral;" and (b) not include new taxes.

5. Even the two leading options--additions to SPRO and aid to industry-- caused substantial debate. While aid to the domestic oil industry has obvious political advantages, it would increase production now but not help energy security in the 90's. Further, there is reluctance to begin discussions of tax breaks so quickly after enacting tax reform. The SPRO fill was clearly the prime option, but even at current oil prices it is extremely expensive. The goal is for a SPRO of 750 million barrels by the mid- to late 1990's, as compared to the current level of 516 million. The options relate to the rate of fill.

6. Because of diverse interests--the free market, the oil industry, and the budget--the meeting should be lively. You should be aware that OMB is suggesting (as a red herring) that additions to US oil reserves be made contingent on other countries making similar efforts. Nearly everyone at the table will understand that other countries will not follow suit.

7. Because the draft background and options package is being revised significantly on Friday, I am not including it and will pass on the final version when it arrives Monday.

Deane E. Hoffmann

Attachments:

A. Talking Points on Instability and Oil Security in the Persian Gulf, NESA paper, 9 April [redacted] 25X1

B. Background Paper on DOE Energy Security Study, OGI paper, 9 April [redacted] 25X1

C. Definition of Energy Security and US Interests, OGI paper, 9 April [redacted] 25X1

D. Arabian Peninsula: Prospects for Political Change, NESA NESR 15 August 1986 [redacted] 25X1

SECRET [redacted]

25X1

SUBJECT: 14 April Joint EPC/DPC Meeting on Energy Security

NIO/Econ/DHOFFMANN [redacted] 10 April 1987 NIC 01624-87

25X1

Distribution:
Original - Addressee
1 - D/Exec Staff
1 - Exec Reg
1 - C/NIC
1 - VC/NIC
1 - NIO/NESA
1 - D/OGI
1 - [redacted] OGI (Room 3G31)
1 - D/NESA
1 - [redacted] NESA (7G00)
2 - NIO/Econ Files

25X1

25X1

SECRET

25X1

Talking Points for the ADCI
Instability and Oil Security in the Persian Gulf
9 April 1987

Continued political volatility in the Persian Gulf region will generate risks to the flow of oil well into the 1990s.

Although the countries on the Arabian Peninsula have remained intact and pursued consistently moderate policies over the past several decades, they will face continuing, and perhaps increased, political, economic, and social stress in the years ahead.

--A prolongation of the depressed economic conditions in the Gulf monarchies is likely to stimulate increased political activism that could lead to periods of protracted instability in some states.

--The rising expectations of increasingly educated and rapidly growing populations will pose complex challenges to these states.

--Ethnic and religious tensions, particularly in Kuwait, Bahrain, and to a lesser extent Saudi Arabia's Eastern Province, are unlikely to dissipate and may well worsen, fueled by the region-wide fundamentalist trend.

--The security relationship with the United States, while a vital element of the national security policy of each of the Gulf monarchies, will continue to be a lightning rod for political opposition.

--Interstate conflict on the Peninsula will remain an ever-present risk as a result of festering border disputes and historical rivalries.

Post-Khomeini Iran is likely to witness an intense power struggle and possibly protracted instability.

--There is a good chance that more radical clerics will remain powerful. Should they gain a dominant position, Iran would likely pursue a policy of greater isolation, be more confrontational with the West and Tehran's Gulf neighbors, and pursue more radical oil policies.

25X1

The 6-year-old Iran-Iraq War shows no sign of ending and poses the most likely continuing threat to the physical production and movement of oil.

--In 1986 alone the two combatants attacked nearly 100 oil tankers in the Gulf and Iraq repeatedly struck Iran's oil production facilities, although these attacks did not diminish significantly the flow of oil from the Gulf.

--Of the war's potential outcomes, an Iranian victory would be most damaging to Western oil interests. The Shia populations in the Arab Gulf states would become more politicized. Iranian control of Iraqi oil policy and influence over Kuwaiti and Saudi policy would make Tehran a much more formidable power in OPEC.

--The war has spurred a trend to find alternative routes for exporting oil that skirt the Strait of Hormuz chokepoint. This trend may ultimately dilute the threat to oil security if pipelines continue to be built that allow Persian Gulf oil to be exported through the Mediterranean, Red Sea, Gulf of Oman, and Arabian Sea ports.

Dramatic developments in the Arab-Israeli arena could again bring Middle East politics to the forefront of oil policy decisions.

--The Intelligence Community judges that the chances are high for a major conflict between Syria and Israel before the end of this decade.

--Under circumstances of growing Western dependence on Persian Gulf oil, the use of oil as a political weapon would regain credibility.

With roughly 55 percent of the world's proven oil reserves, the Persian Gulf will remain a focus of US-Soviet competion for influence.

--A Soviet military move into Iran, while currently a remote possibility, would have major consequences for Western access to oil.

--The US security presence in the region has declined markedly in the past decade as a result of the overthrow of the Shah, the decline in the US weapons relationship with the Gulf Arabs, and growing Arab military self-reliance.

25X1

9 April 1987

DOE Energy Security Study

Background--CIA Role

In September 1986, following the sharp fall in world oil prices, the President commissioned the Department of Energy to prepare an interagency study on energy security in response to his concern over declining domestic oil production and rising oil imports. At the request of Deputy Secretary of Energy William Martin, OGI staff provided most of the world energy outlook section of the study.

25X1

25X1

Summary of Findings

The energy security study found that lower supplies from non-OPEC countries, especially the United States, combined with higher oil consumption will leave the world more dependent on Persian Gulf oil supplies in the 1990s. This outlook and the impact of the price fall on the domestic petroleum industry has potentially serious implications for US national security.

25X1

Rising Dependence on Imported Oil

The price fall already has led to fundamental shifts in market trends--declining non-OPEC supplies and rising consumption--that will cause the West to become more dependent on OPEC and Persian Gulf oil producers.

/o/ The price slide has affected US oil production because the US is the world's high cost producer. US output declined last year and is expected to fall another 400,000 b/d this year.

/o/ The Free World gets half of its energy from oil and oil meets over 40 percent of US energy consumption. Oil will remain a critical component in the world energy market.

25X1

To bracket likely Western and US dependence on OPEC and Persian Gulf oil producers by 1995, two oil price paths were examined:

/o/ A higher dependence case with an oil price of $15 per barrel until 1990 rising to $23 by 1995.

/o/ A lower dependence ease of steady price increases from $15 per barrel in 1986 to $28 in 1995.

25X1

/o/ Under these cases, free world dependence on OPEC oil rises from 40 percent now to 45-60 percent by 1995; dependence on Persian Gulf producers increases from 25 percent to 30-45 percent.

--For the US, net oil imports rise from 5.2 million b/d in 1986 (33 percent of consumption) to 8-10 million b/d (50 percent of consumption) by the mid-1990s.

Risks of Disruptions--Increasing Producer Leverage

Rising dependence on OPEC and Persian Gulf oil implies a greater vulnerability to oil supply disruptions and greater economic and national security risks for the United States and our Allies. Energy security depends in part on the ability of importing nations to respond. Consuming countries have taken steps to increase strategic oil stocks, but the risk of a large oil supply disruption in the Persian Gulf that damages the economies of the United States and allied nations remains. Interconnected world markets dictate an international approach to increasing energy security.

Study Conclusions

Secretary Herrington concludes there is justification for national concern over rising US and Allied dependence on imported oil and on the declining competitiveness of the US petroleum industry. The Energy Security study examines policy options and impacts to deal with the outlook, but makes no explicit recommendations. Implictly, however, the study concludes that the economic and trade costs of an oil import fee outweigh energy security benefits.

9 April 1987

Definition of Energy Security and US Interests

Growing US dependence on an unstable supply of Persian Gulf oil adversely affects national security in several ways:

--Economic Impact. National security is enhanced by the continuation of stable, low oil prices and a market-based energy system. Strategic stocks provide the capability to mitigate most of the economic impact of major disruptions. As the cushion of surplus production capacity diminishes and dependence on foreign sources grows, the US ability to cope will be reduced. Supply disruptions or price manipulation could then seriously damage the world economy and undermine the US ability to pursue its security objectives.

--Defense Requirements. Disruptions can hamper defense readiness and sustainability during periods of international crisis or during times of war, although defense needs are small relative to overall oil consumption. Ensuring that defense needs are met could mean that discretionary civilian consumption would yield to security requirements in an emergency.

--Foreign Policy Implications. Increasing dependence on Persian Gulf oil reduces US flexibility in foreign policy, both in the Middle East and worldwide. Our willingness to pursue other fundamental long-term interests could be reduced if special priority must be accorded to ensuring an adequate oil supply. The leverage that hostile oil producers such as Iran and Libya can use against the US and its allies is increased, as is their ability to pursue radical regional policies. Support from Western allies may also be reduced as they respond to their own vulnerabilities and competition for oil.

25X1

Near East and South Asia Review

25X1

Articles

Arabian Peninsula: Prospects for Political Change

25X1

The traditional authoritarian governments of the Arabian Peninsula will face increased political, economic, and social pressures over the next decade, and most, if not all, regimes probably will undergo political change before the end of the century. The smaller Gulf states are the most vulnerable to political unrest and upheaval, but even the Saudi monarchy is likely to undergo significant change that will reduce royal family control over decisionmaking. Political change would not necessarily be inimical to US interests, but instability probably would invite meddling by external elements hostile to the United States.

The structural weaknesses and political vulnerabilities of the traditional authoritarian regimes of the Arabian Peninsula—Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates, and Oman—frequently are overlooked or discounted by political observers because of their recent impressive record of political stability. Comparisons with the Iranian experience are minimized because of the extensive differences between Persian society, culture, and politics and those of the Sunni regimes on the Arab side of the Gulf. Denials of an Arab-Persian parallel ignore the fragility of these states, however, and usually result in overly optimistic assessments of their ability to weather the political challenges ahead.

Foundations of Stability

While labor unions, student groups, Islamic organizations, nascent political institutions, leftist movements, and secular ideologies were transforming the internal politics of most Middle Eastern states beginning in the 1950s, the political development of the Arab Gulf states moved at a glacial pace. Although most Gulf states experienced limited effects of these regional political developments and influences, most internal changes were merely cosmetic. Significant structural change was initiated only in Bahrain and Kuwait—the most urban and socially developed of the Gulf states—in the form of labor unions, political parties, legislatures, and formal constitutions, but even these limited changes were eventually blunted by ruling families unwilling to jeopardize their political control.

25X1

The political stability of these states over the past 30 years has been particularly remarkable in light of the rapid and extensive economic and social development they have undergone. This stability was the product of a confluence of factors that made these states unique within the Middle East and enabled traditional ruling families to maintain political power:

- *Oil wealth.* The most significant influence on the Persian Gulf region over the past 30 years has been oil-generated economic prosperity. The standard of living of most residents of the Gulf states has increased dramatically.

25X1
25X1

Consequently, economic disaffection, frequently a source of political activism in other Middle Eastern states, has been insignificant.

25X1

- *Small, rural, and mostly uneducated populations.* Inhospitable climates, poor medical care, virtually no resources other than oil, and terrain unsuitable for agriculture kept populations mostly sparse and scattered until the 1970s. Moreover, literacy rates and educational levels were extremely low, and indigenous intelligentsias were numerically insignificant. Burgeoning public and private sectors

easily assimilated the few university graduates among the native populations, usually at highly inflated salaries.

- *Undeveloped political institutions.* The simplicity of the tribal political system and the lack of a tradition of popular participation in government allowed the ruling families to rule virtually unchallenged. The few politically significant interest groups that did exist were generally co-opted by regimes once oil money began to flow with some regularity in the 1950s. Political power in these states traditionally had been the preserve of tribes that controlled the greatest resources—men, herds, water, trading routes—and Western political institutions like political parties, elections, free press, and legislative bodies were foreign concepts that had little popular support or relevance. Bahrain abandoned its parliamentary experiment in 1975, and Kuwait's ruling Sabah family dissolved the National Assembly in 1976 and again in 1986 when it began to challenge the authority of the regime. This dearth of channels for political participation helped thwart nascent political activism throughout the Gulf states.

- *Limited foreign exploitation.* Although all of the Gulf states had some experience of foreign occupation and influence, outside powers made little attempt to colonize the region. Unlike the Levant, Egypt, and North Africa, where there was extensive exploitation and development of indigenous resources by colonial powers, the Gulf states were valued only for their ports and trading routes. Consequently, tribal systems were allowed to flourish, and traditional ruling families were in control when modern nation-states were founded in the 20th century. Foreign powers dealt mainly through existing tribal leaders, helping solidify the political control of traditional ruling families.

- *Fledgling military forces.* Despite a strong martial tradition among the tribes, the fledgling military forces of the Gulf states have been artificial and usually imported creations of the central government that pose little political threat to their stability. Native professional military officers frequently pursue their private business pursuits with greater vigor, and the politization of junior officers that occurred in Egypt, Libya, Syria, Iraq, and the Yemens has not been imitated in the Gulf.

25X1

These factors and generally judicious rule have abetted political stability in the six Gulf states. The few abrupt internal political changes that took place in Saudi Arabia (1962), Abu Dhabi (1968), Oman (1970), and Qatar (1972) were internal family matters that displaced generally inept rulers. Although antiregime sentiment has been prevalent in the Gulf states for the past 30 years, no regime has been on the brink of collapse because of internal pressure.

25X1

1986-2000: A Period of Political Adjustment

The foundations of political stability of the past 30 years are eroding and becoming increasingly irrelevant, and changing political, economic, and social environments are likely to stimulate increased political activism in most Gulf Arab states before the end of the century. Ruling families will face more complex challenges to their rule as they try to meet the growing and frequently unrealistic expectations of increasingly educated and heterogeneous populations. Most—if not all—of these authoritarian regimes will be unable to meet these expectations and, as a result, will probably undergo significant change in their political systems. Some regimes may even be replaced. The principal factors contributing to increased political activity are:

- *Economics.* Even if oil export earnings were to increase over the next several years, the economies of the Gulf Arab states would rebound only gradually and are unlikely to return to the boom years of the 1970s. Government spending will remain below previous levels, and the growth of the private sector will continue to be slow. At the same time, a steadily increasing number of young and miseducated Gulf Arabs will be entering the labor market, only to be disappointed at the lack of business and employment opportunities. The resultant increase in underemployed Gulf Arabs will contribute to heightened political restiveness among youth. Moreover, conspicuous ruling family

spending no longer offset by unbounded oil-induced prosperity will increase criticism of the regimes. Unlike in the 1970s when regimes co-opted critics and maintained popular support by freely dispensing petrodollars, lower revenue levels will prevent governments from employing the same strategy to alleviate economic and political problems.

- *Demographics*. The increasing urbanization, youth, and education of Gulf societies will present new and complex challenges to ruling families. Urban maladies like increasing crime rates, narcotics, and inadequate housing already are affecting major cities, and urban lower and lower-middle classes are the fastest growing segments of Gulf populations. The austere social environments of the Gulf states also are promoting restiveness among youth, who have been exposed to Western cultures but will be increasingly unable to afford diverting jaunts to Western playgrounds. At the same time, the growing literacy and educational levels of these populations—nearly one out of every four Gulf citizens is a student—will contribute to more politically astute, informed, and demanding populations.

- *Interest groups*. Rapid economic development in the Gulf has increased the influence and resources of several traditional and new interest groups—for example, the religious establishment, military and security services, major merchant families, technocrats, youth, women, and urban middle classes. Intelligentsias, the traditional spawning grounds of political activists in other Middle Eastern states, also are appearing throughout the Gulf states, and their scrutiny of government policies and their dissatisfaction with being excluded from participation in government are likely to mount. Also increasing will be interest group identification, especially if grievances with regimes become more pronounced and economic austerity leaves interest group expectations unmet. If governments continue to inhibit the development of political institutions that could serve as controlled channels for popular frustration, some interest groups may choose to engage in clandestine political activities.

- *Social tensions*. Growing tension between modernists and traditionalists in the Gulf Arab states will complicate regime efforts to satisfy their minimum and frequently contradictory demands. Although the forces of Islamic fundamentalism and social conservatism have been buttressed by the Iranian revolution, the forces of modernization and Westernization remain formidable. Social conservatives will try to prevent forcefully the growth of Western influence, increasing the likelihood of confrontation between the two groups.

- *Regional developments*. Another Arab-Israeli conflict, a widening or intensification of the Iran-Iraq war, a sharp upsurge in anti-US sentiment in the Arab world, or confrontations among Gulf states over border issues—all distinct possibilities before the end of the century—have the potential to weaken the political stability of the Gulf ruling families. The increased prominence and influence of these states in regional affairs increase chances they will become embroiled in regional conflicts. Their involvement will be closely evaluated by their own populations, and unpopular responses or failed policies might prompt domestic backlashes. These states also might become increasing targets of externally sponsored terrorism or sabotage, which would spark popular criticism of ruling family inability to provide protection from outside threats.

25X1

Implications for US Interests

The gradual dilution of ruling family political power in the Arab Gulf states would not necessarily harm US interests. The inclusion of more commoners in decisionmaking—whether in executive or legislative bodies—and the development of more representative governments probably would have the greatest impact on internal policies. Nonetheless, relations with the United States probably would be subject to greater internal review and approval, and foreign policy decision making almost certainly would be slowed as a result. Stronger governmental criticism of US Middle East policies also probably would surface, but bilateral ties probably would not suffer a serious setback.

25X1

A transfer of political power to established Western-educated elites like nonroyal government officials, technocrats, businessmen, or military officials probably would have little significant impact on bilateral relations with the United States or US economic and commercial interests in the country. Although such regimes probably would try to legitimize their rule by lending greater vocal support to popular Arab and Islamic causes, they probably would maintain the foreign policy orientation of current regimes. The major exception might be Bahrain, where a government controlled by the Shia majority probably would expand ties to Iran and seek to reduce Western influence in the country.

25X1

US interests would be most threatened by political instability that resulted in interference by countries or external groups hostile to the United States. Iran and fundamentalist Islamic, particularly Shia, organizations probably would try to exploit political unrest in any Gulf state by carrying out terrorist attacks or instigating trouble in Shia communities. Radical domestic groups probably would receive external support, and their antiregime activities probably would include an anti-US focus.

25X1

25X1

EXECUTIVE SECRETARIAT

ROUTING SLIP

TO:		ACTION	INFO	DATE	INITIAL
1	A/DCI	X			
2	DDCI				
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA				
7	DDO				
8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/OCA				
14	D/PAO				
15	D/PERS				
16	D/Ex Staff		X	8 APR 1987	
17	NIO/ECON		X		
18					
19					
20					
21					
22					
	SUSPENSE				

Date

Remarks

Executive Secretary
13 Apr '87
Date

3637 (10-81)

25X1

THE WHITE HOUSE

WASHINGTON

April 10, 1987

MEMORANDUM FOR THE DOMESTIC AND ECONOMIC POLICY COUNCILS

FROM: RALPH C. BLEDSOE
Executive Secretary, DPC
EUGENE J. MCALLISTER
Executive Secretary, EPC

SUBJECT: Joint Meeting on April 14, 1987

A joint meeting of the Domestic and Economic Policy Councils will be held on Tuesday, April 14, 1987 at 11:00 a.m. in the Roosevelt Room. The issue to be discussed is Energy Security.

A paper outlining the Working Group's recommendations is attached for your review.

SECRET ATTACHMENT

THE WHITE HOUSE

WASHINGTON

DOMESTIC POLICY COUNCIL AND ECONOMIC POLICY COUNCIL JOINT MEETING

Tuesday, April 14, 1987

11:00 a.m.

Roosevelt Room

AGENDA

1. Energy Security -- Secretary Herrington

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL AND DOMESTIC POLICY COUNCIL

ISSUE: Do energy trends pose a national security threat? If so, are current policies adequate? If not, what new initiatives are required?

BACKGROUND

In September 1986 the President directed the Secretary of Energy to conduct an interagency review of the energy security of the U.S. The Congress affirmed this directive in the FY 1987 Budget Reconciliation legislation and asked the President to submit views on the impact of oil import levels on U.S. energy security.

In its study, completed in March 1987, DOE drew several conclusions about the world oil situation and possible actions that the U.S. might take. To assist the President in formulating a response to the Congressional request, the study's conclusions have been reviewed by the Domestic Policy Council Working Group on Energy, Natural Resources and Environment. This paper contains information developed by the Working Group, including options for consideration by the President.

World Situation

World oil prices suddenly collapsed in 1986, falling by more than 50% from $27 in early 1986 to about $10 a barrel at mid-year, before rebounding to $18 a barrel in early 1987. Oil prices, however, are under pressure and the outlook remains uncertain.

Lower oil prices have brought significant benefits to the national economy and to consumers. Lower prices have led to the lowest inflation level in 25 years, which in turn, contributed to lower interest rates. Unemployment is at its lowest level in seven years. And lower oil prices have favored individual energy-users such as the average car owner, who saves about $165 a year through lower gasoline bills.

Despite the overall benefits to the economy, the oil industry has been badly hurt. The sudden collapse in prices shocked the domestic oil and gas industry. Oil company budgets were slashed, and 300,000 jobs were lost in 1986. Job losses represent 26% of the oil and gas workforce. U.S. oil production fell by 800,000 barrels per day in 1986, with an additional loss of 400,000 or more expected in 1987. To date, U.S. oil production has fallen by nearly one million barrels per day (includes natural gas liquids).

SECRET

NO FOREIGN DISSEMINATION

Although projections are inherently uncertain, a range of oil price projections developed for the Energy Security Study indicates that if present trends persist, U.S. net oil imports will rise from 33% to 37-55% of U.S. consumption by 1990-1995 (6 to 8 million barrels per day in 1990 and 8 to 10 MMBD in 1995). Two-thirds of this rise in oil imports is a result of the projected 2-3.4 MMBD decline in U.S. oil production and the remainder is due to rising consumption. The market share for OPEC countries (whose production comes primarily from the Persian Gulf) would rise from 40% to 45-60% by the early 1990's -- comparable to OPEC's market share in the 1970's.

Growing reliance on oil from unstable Persian Gulf suppliers increases the likelihood of oil supply disruptions. Disruptions in the 1970's contributed to the largest economic recession since the 1930's. The effects of the disruptions were exacerbated by the imposition of price and allocation controls. Today we are in far better shape to respond to a supply disruption that might occur in the 1990's than we were in the 1970's. Emergency stocks worldwide, over 900 million barrels including the SPR, will be sufficient to respond to net reductions in supply twice as large as those of the 1970's.

A very large disruption in the 1990's, although unlikely, is possible. It could disrupt more than 5 million barrels per day of oil (even after accounting for increased production and stock drawdown in non-disrupted regions). Analysis indicates that if such a large scale disruption occurred (which would be two to three times as large as historical size disruptions) and lasted for 6 months, oil prices might rise by $18 to $50 per barrel (even with a rapid drawdown of the SPR). As a result of higher prices, even with a rapid drawdown of the SPR, U.S. GNP could drop temporarily by 1 to 2 percent or $40 to $110 billion below where it would otherwise have been. There also could be a transfer of wealth from the U.S. to oil-producing countries due to higher oil prices -- similar economic losses would be felt by other net oil-importing nations.

Such disruptions would again cause economic dislocations. Rapid and effective response by the Government, including SPR drawdown and avoidance of ill-conceived policies such as price and allocation controls, will help prevent the losses in economic performance that occured in the 1970's. A panicked reaction could jeopardize the gains made by the Administration in decontrolling oil prices and deregulating the oil industry.

General Working Group Recommendations

In response to the current world situation, the Working Group recommends that we take steps to protect ourselves from potential supply interruptions and increase our energy

security. These steps should include: increasing our domestic stockpiles, which we can draw down in the event of a supply interruption; maintaining a strong domestic oil industry; expanding the availability of our oil and gas resources; and promoting among our allies the importance of increasing their stockpiles. Our response to potential supply interruptions must be an allied response. The Working Group unanimously concurs with the DOE conclusion that the cost of an oil import fee outweighs the benefits.

Present Programs and Agreed Policies

The Administration's basic energy policy is to rely primarily on energy markets, supplemented by the SPR. The Administration is also concerned about undue reliance upon a single source of supply or a single set of suppliers. The importance of energy to our economic competitiveness and national security is well recognized, and during the first six years of this Administration major gains were achieved in strengthening our foundation for long-term energy security:

- Decontrolled oil prices in 1981 which allowed domestic production to increase through 1985 and continue to restrain demand.
- Reduced the Economic Regulatory Administration workforce from 2000 to 200.
- Significantly cut-back spending on ineffective energy programs such as synthetic fuels.
- Preserved treatment of intangible drilling costs in the tax reform bill and retained the full-cost accounting provisions.
- Filled the Strategic Petroleum Reserve to more than half a billion barrels and committed to a 750 million barrel goal.
- Reestablished the 5-year OCS leasing program and reduced the minimum bid for certain offshore leases.
- Increased the budget for clean coal to $2.5 billion over the next 5 years and reestablished a Federal coal leasing program.
- Lifted foreign policy controls on the export of petroleum equipment and technology.

- Encouraged allied stockbuild and improved West European natural gas security through the conclusion of the Troll Sleipner project.

- Continued gains in energy conservation from individual actions, with consumers making their own decisions to use energy more efficiently.

New proposals supported by the Administration need to be pursued vigorously and include:

- Comprehensive natural gas decontrol including wellhead price decontrol, mandatory contract carriage and repeal of demand restraint.

- Repeal of the Windfall Profit Tax.

- Continue to improve access to OCS and federal lands and proceed administratively on leasing and royalty issues including reducing royalties for certain coal leases; initiating congressional procedure for OCS moritoria similar to Gramm-Rudman-Hollings; providing that Wilderness Study Areas, properly recommended to Congress as unsuitable, be released for multiple purpose use; and other similar approaches.

- Clarify for exemptions for small temporary collection devices and consider permitting land treatment of oil and gas wastes.

- Nuclear licensing reform, reauthorization of the Price-Anderson Act, and progress in development of a nuclear waste repository.

- Take a hard look at introducing more competition into electric power markets.

- Aggressively push for higher levels of strategic oil stocks in all countries at the ministerial meeting of the International Energy Agency in May, followed by the President addressing the matter at the Venice summit.

- Evaluate regulatory changes to facilitate the use of alternative fuels (alcohol and compressed natural gas) for the transportation sector.

DISCUSSION

Administration policies implemented to date and previously approved proposals will contribute to a more secure energy future in the long term. If all policies are implemented (particularly comprehensive natural gas deregulation), these policies can yield additional production of 375,000 barrels per day of oil equivalent within a 3 to 5 year period.

SECRET

Against this backdrop, the EPC/DPC should focus on: 1) To what degree is there a national security threat? 2) Are present policies adequate? 3) Should the Administration adopt DOE's three-pronged approach for enhancing energy security? 4) How should new initiatives be funded?

Is There a National Security Threat?

The national security implications of projected levels of dependence on insecure sources of oil are significant. The following discussion has been prepared by the State Department, the Department of Defense, the Central Intelligence Agency and the National Security Council.

Growing Reliance on Insecure Oil Affects National Security Interests

Over the next decade, the West, including the United States, will become more dependent on insecure oil supplies, particularly from the Persian Gulf. This poses a threat to US national security interests. The decline in surplus production capacity will leave the West more vulnerable to supply disruptions, price manipulation, and attempts to use oil as a political weapon. (C/NF)

Political Instability in the Persian Gulf

Increased dependence on the Persian Gulf for oil supplies is a concern because of the continuing volatility in the region and the threat of a supply cutoff or a major supply disruption. The course of the Iran-Iraq war, an almost certain power struggle in post-Khomeini Iran, and Soviet competition for influence in the region all influence Western access to Persian Gulf oil. Furthermore, developments in the Arab-Israeli arena could again bring Middle East politics to the forefront of oil policy decisions as they did in 1973. (C/NF)

The countries in the Arabian Peninsula will face continuing and perhaps increased political, economic, and social pressures over the next decade. The political stability of these states over the past 30 years has been particularly remarkable in light of their rapid economic and social development. Changing political, economic, and social environments, however, are likely to stimulate increased political activism that could lead to periods of instability in some of these states before the end of the century. Ruling families will face more complex challenges as they try to meet the rising expectations of increasingly educated

SECRET

NO FOREIGN DISSEMINATION

and rapidly growing populations. Thus when combined with the hostility between Iran and Iraq the risk of political instability in the Persian Gulf area will remain high. (S/NF)

Although political change on the Arabian Peninsula would not necessarily be inimical to US interests, instability could be exploited by external elements hostile to the United States. Radical domestic groups probably would receive external support, and their antiregime activities may well include an anti-US focus. (S NF)

U.S. Interests

Energy security policy must deal with two environments -- reducing our vulnerability to supply disruptions prior to their occurrence and preparing us to cope with supply interruptions.

National security is affected by our energy situation in several ways:

- Economic Impacts. Strong economies are essential to Western security. Thus, national security is enhanced by the contribution lower oil prices and a market-based energy system make to economic growth and efficiency. Strategic stocks give oil-importing nations the capability to mitigate most of the economic impact of historic-sized disruptions. However, as the cushion of surplus production capacity diminishes, our ability to cope will be reduced. Under these conditions, supply disruptions or price manipulation could seriously damage the world economy and undermine our ability to pursue our security objectives. (C/NF)

- Defense Requirements. Although defense needs are small relative to overall oil consumption, disruptions can hamper defense readiness and sustainability during periods of international crisis or during times of war. Moreover, defense needs in a major conventional conflict would include industrial mobilization. Ensuring that defense demands are met may mean that discretionary civilian consumption would yield to security requirements in an emergency. (U)

- Foreign Policy Implications. Increasing dependence on insecure oil can hamper pursuit of U.S. security and foreign policy interests. Heavy and growing reliance on the Persian Gulf region requires that we continue to devote limited defense readiness resources to this area, stretching our global defense capabilities. Our own political willingness to pursue fundamental long-term interests could be reduced if special priority must be accorded to ensuring oil supply. Support from Allies could also be reduced if they respond to perceived vulnerabilities and rivalries for oil supplies, thus undermining Allied solidarity and complicating the

management of a major crisis. Heavy reliance on the Persian Gulf may also reduce Allied willingness to provide access to military facilities essential for U.S. capabilities to respond to crises in the Middle East/Southwest Asia region. Following the U.S. bombing of Libya, for example, Tripoli pressed hard for an Arab oil embargo against the United States and Allies who supported the effort. The Arab world -- including Egypt -- strongly condemned the U.S. action, but did not pursue an embargo in part because of the abundance of alternative supplies. In a tight oil market, fear of unified Arab retaliation might have stiffened Allied resistance to the bombing. (S/NF)

Energy security can be achieved only on a collective basis. Measures aimed at ensuring our access to oil supplies at the expense of our Allies not only will fail, but also will encourage them to pursue go-it-alone strategies that are likely to be harmful to our interests. ~~In contrast~~, cooperative efforts to reduce collective vulnerability give the United States greater flexibility in foreign policy and add to our national security. National security is enhanced when the U.S. and its Allies minimize, in a cost effective way, the risks of a supply disruption (and maintain the capability to mitigate its impacts should one occur). (U)

Should the Administration Adopt DOE's Three-Pronged Approach?

If council members conclude that projected falling U.S. production, growing OPEC market share, and increasing dependence on Persian Gulf oil jointly pose and increase a national security threat, they should assess the adequacy of present policies and consider any new policy initiatives that may be needed.

DOE and others believe that present policies are not adequate. Growing dependence on insecure sources of oil exposes the Nation to the threat of supply disruptions, places economic power in the hands of foreign cartel members, exposes our economy and industry to oil market manipulation, constrains the conduct of foreign policy and limits our freedom of action in strategic areas of the world. This represents a serious national security threat that requires strong action by the Administration. The President has stated that the United States must not become hostage again to a foreign oil cartel and that the Nation must maintain a viable and competitive domestic oil and gas industry. In recognition of the President's goals, DOE has proposed a goal of increasing oil and gas production by up to 1 million barrels per day in the early 1990's which includes the amount of lost production in 1986 and to thereby reduce increasing dependence on imported oil. DOE proposals are targeted to increasing domestic production and finding new U.S. reserves and are designed to stimulate drilling in the U.S. to help sustain the oil service industry and independent oil and gas infrastructure which drills 85% of new wells in the U.S.

Some hold the view that present policies are adequate and that it would be consistent with Administration policy to let markets, rather than government, allocate resources. It is pointed out that the proposed new tax and spending initiatives could add as much as $8 billion over five years to the cumulative budget deficit. Supporting tax incentives for the oil industry would make it difficult to fend off demands for special tax treatment for other energy sources and other industries with national security claims such as steel, semi-conductors and airframes. In addition, offering tax incentives for the oil industry dissipates administration political capital and diverts time and attention from proposals, such as natural gas decontrol, which are consistent with market economics and deserve Administration support. Additional initiatives could launch a government directed oil import reduction campaign and undercut national security by weakening the economy and reducing resources in the federal budget available for defense and other national security purposes.

The Department's proposal to increase U.S. oil and gas production by one million barrels per day partially consists of previously-approved but not yet implemented market-based incentives (mainly natural gas deregulation). These market-based initiatives will result in increased U.S. production of oil and gas of 375,000 barrels a day, or 40 percent of DOE's target. The remainder would result from a series of proposed new tax incentives. This total increase in U.S. energy production, equivalent to 1 million barrels per day of oil, would raise domestic oil and gas production by about 6 percent above what it would otherwise be. This gain would reduce projected net U.S. oil imports by 8 to 11 percent. If achieved by 1992, the gain in U.S. production would reduce world dependence on Persian Gulf production by 0 to 5 percent, depending upon OPEC response. It should be noted that roughly 30% of these effects result from natural gas deregulation.

To provide enhanced energy security and reduce dependence on insecure foreign sources of oil, DOE has recommended a three-pronged strategy. First, temporary tax incentives to stimulate oil exploration and development. Second, exploration of the Arctic National Wildlife Refuge, which could have oil reserves comparable to Prudhoe Bay. And third, a faster build of emergency stocks. These and other options developed by the Working Group are described below.

1. TAX INCENTIVES

DOE recommends the following items as a four-part energy security tax package designed to encourage exploration and development drilling and to preserve stripper and other marginal wells. The first two items were previously approved by the EPC with a sunset provision at $20.

ITEM 1: Repeal the transfer rule, to permit use of percentage depletion for proven properties which have changed ownership.

The estimated cost of repealing the transfer rule averages $17 million per year, or $85 million for the five year period in lost tax revenues from 1988-1992. Oil and gas production would increase by 55,000 barrels per day by 1990, largely from maintaining low-production wells that otherwise would be abandoned.

ITEM 2: Increase the net income limitation on the percentage depletion allowance from 50% to 100% per property.

The cost of increasing the net income limitation is $31 million per year, or $155 million for the five-year period in lost tax revenues from 1988-1992. This option would maintain oil and gas production of 58,000 barrels per day from marginal properties that would otherwise be shut-in by 1990.

ITEM 3: Provide for faster recovery of Geological and Geophysical (G&G) expenses, with a phase-out of the option as oil prices rise from $21 to $25 per barrel.

G&G costs include work that precedes exploratory drilling. Currently, these costs (which account for about 12% of exploratory costs) must be capitalized and recovered over the producing life of the asset. Permitting the recovery of G&G costs, as is now allowed for intangible drilling costs (IDCs), would simplify oil company recordkeeping and speed up the recovery of these costs.

The average annual cost of this provision in lost tax revenues would be $306 million per year from 1988-1992 (resulting in increases in tax collections by 1994). The five year revenue loss is $1.53 billion. The provision would increase oil and gas production by 200,000 barrels per day by 1992.

PROS:

- o The incentive is among the most efficient of those considered.
- o G&G costs can be viewed by some as similar to research and development costs and should be accorded a faster writeoff period as are R&D costs in other industries.
- o By targeting G&G expenditures, this option directly promotes an increase in the search for oil and gas reserves, increasing future domestic production capacity.
- o By shifting the time profile of production of oil and gas toward the present, energy security will be increased during the 1990's, a time when the world will be most dependent on oil. Cash flow from new production can be plowed back into further exploration.

- o DOE estimates that shifting the time profile of production to the near term would only marginally reduce the availability of reserves in future years.
- o Phasing out this incentive as oil prices rise curtails cost as price incentives become adequate.
- o Both independent oil producers and the oil service sector reported financial losses for 1986, and the incomes for major producers for domestic operations declined by 65 percent.

CONS:

- o The subsidy amounts to a significant amount per barrel for each additional barrel of increased production and will be viewed as fundamentally inconsistent with the Administration's market reliance energy policy.
- o Major oil companies will be reporting in excess of $12 billion in net income in 1986. Providing a subsidy to them will be viewed by some as a bailout to a profitable sector.
- o Providing a temporary subsidy increases U.S. production in the early 1990's but results in lower U.S. production in the longer term and increased import reliance and reduced security.
- o Without legitimate budget offsets, would substantially increase the deficit at a time when deficit reduction is a high priority.
- o Would be a major compromise to the recently enacted tax reform that eliminated from the tax code most special interest subsidies.

ITEM 4: Provide a tax credit for oil exploration and development on new properties.

Allow an exploration and development drilling credit equal to 10% on the first $10 million of annual drilling expenditures and 5% on expenditures in excess of $10 million.

Expenditures eligible for the credit include E&D drilling and equipping costs on unproven properties, and expenditures to maintain stripper well output, such as maintenance, workover and secondary recovery costs. This credit could be used in full for either regular tax or minimum tax payments, and it would be refundable. The credit would terminate when prices reach $25 per barrel.

The cost of this option is $2.8 billion over five years, of which drilling credits represent $525 million per year from 1988-1992. By making the credit non-refundable, the cost would be reduced by $425 million over five years, or $85 million per year, and the production response would also be reduced.

PROS:

- Directly targets new exploration, drilling, and production by reducing the cost of finding and developing new oil reserves in the U.S. while prices remain low. Production of oil and gas is estimated to increase by 330,000 barrels per day from the refundable drilling credit alone.
- Would slow the abandonment and plugging of stripper wells and encourage workovers and drilling and other producing zones resulting in increased production estimated at 30,000 barrels per day (not already brought on by Items 1 and 2).
- Provides cash flow to many domestic oil drillers, helping to offset damage to the domestic industry caused by the collapse in prices and the decline in investment.
- By shifting the time profile of production of oil and gas toward the present, energy security is increased during the 1990's, a time when the world will be most dependent on oil. Cash flow from new production can be plowed back into continuous exploration.
- DOE estimates that shifting the time profile of production to the near term would only marginally reduce the availability of reserves in future years.
- Since the credit is not restricted to any particular geographic region, the credit would not alter market incentives to explore and develop the most promising areas.

- o Both independent oil producers and the oil source sector reported financial losses for 1986, and the incomes for major producers for domestic operations declined by 65 percent.

CONS:

- o The stripper provisions would provide incentives for some producers to reduce their production levels simply to qualify for the credit.
- o The subsidy amounts to a significant amount per barrel for each additional barrel of increased production and will be viewed as fundamentally inconsistent with the Administration's market reliance energy policy.
- o Major oil companies will be reporting in excess of $12 billion in net income in 1986. Providing a subsidy to them will be viewed by some as a bailout to a profitable sector.
- o Providing a temporary subsidy increases U.S. production in the early 1990's but resulting in lower U.S. production in the longer term and increased import reliance and reduced security.
- o Without budget offsets, would substantially increase the deficit at a time when deficit reduction is a high priority.
- o Would be a major compromise to the recently enacted tax reform that eliminated most special interest subsidies from the tax code.

Summary of Tax Incentives

The four tax items will yield 683,000 barrels per day of additional production and, when combined with natural gas decontrol and California offshore leasing, will contribute over one million barrels per day of oil and gas.

The cost of the tax incentives is $938 million per year or $4.69 billion for the 5 year period.

2. LEASING AND ACCESS TO FEDERAL LANDS

Federal lands have tremendous potential for new significant oil and gas discoveries. Offshore has a potential of more than 11 billion barrels of recoverable oil. Onshore, the Arctic National Wildlife Refuge alone has a potential of up to 30 billion barrels of oil in place with a recoverable reserves potential of up to 9.2 billion barrels.

ITEM 1: Open the Arctic National Wildlife Refuge for Oil and Gas Exploration. "Leasing through an orderly public process in a manner fully respective of the environment".

PROS:
- o The coastal plain of the Arctic National Wildlife Refuge (ANWR) is the nation's best single prospect for major new reserves (up to 9.2 billion barrels of recoverable oil).
- o Production potential could be up to 1.5 MMBD coming on stream beyond 1995 as a long-term replacement for Prudhoe Bay production.
- o ANWR production could use available pipeline capacity as Prudhoe production declines.
- o New ANWR production would replace an equal volume of import demand.

CONS:
- o Oil exploration activities could impinge on this environmentally fragile region.
- o This region is habitat to wildlife and has historically served as a source of subsistence for some native populations.

ITEM 2: Reduce the minimum bid requirement for Federal leases from $150 per acre to $25 per acre.

PROS:
- o At the present minimum, a bidder must offer at least $864,000 for the typical 5,760-acre tract. At $25 per acre, the minimum bid for a standard tract would only be $144,000.
- o This option could increase the number of leases bid on and awarded by as much as 40 percent of lease sales in the Gulf of Mexico.

- o Increased leasing would likely increase production, depending on future oil prices (no estimate of production response is available). Increased royalties from increased production would offset some of the lost bonuses from reducing the minimum bid.

CONS:

- o Bonus receipts could drop about $100 million for the FY 1988 to FY 1992 period. Applying a $75 per acre minimum bid to deep water tracts only would reduce receipts in the FY 1988 to FY 1992 period by about $20 million.

- o Opponents may wrongly claim that the government was selling the Nation's natural resources (which belong to everyone) at too low a price.

ITEM 3: New competitive lease sales would be offered with no royalty requirement.

PROS:

- o Bidding on new leases would reflect the expected present value of future earnings on the leases free of royalties. This means the government, including state governments, would receive their payment up front. This is equivalent to additional revenue of $2 to $3 per barrel to lease operators.

- o Some tracts that would not have been bid on because of the obligation of paying royalty would now receive bids, increasing the amount of oil produced. Producers will maintain production longer, without the need to go through an administrative royalty reduction procedure.

- o Total oil production and near-term receipts by the government should go up. Federal bonus revenues on offshore oil should rise about $220 million in FY 88 and about $1.5 billion in total from FY 88 through FY 92.

- o The production gain begins 5 or more years after leases are issued. Additional production would be about 20,000 b/d in 1995 and 60,000 in 2000.

CONS:

- o Drilling activity on Federal lands could be reduced if lessees cannot fund the up-front cost of lease bonuses compared to deferred royalties lessees.
- o Federal revenues would be reduced (long-term present value) if lessees have cash constraints, or are more sensitive to risk on a limited portfolio of leases than the government is on its large portfolio of all leases.
- o To the extent lease bids rise to match royalty reductions, some of the increased lease value will be eroded.
- o Risk that no oil will be recovered is shifted to the lease operators from the government as landowner.
- o States may demand their normal share of Federal royalties, which would increase Federal outlays by as much as $20 million per year.

3. Exports of Californian Crude Oil

Item 1: Remove the restrictions which now exist on exporting crude oil from California.

Commerce estimates that, if these restrictions were eliminated, exports would increase about 50,000 to 100,000 barrels per day.

PROS:

- o Can be done administratively, by a finding (such as the Commerce Secretary made in 1985 authorizing oil exports to Canada) that exports are in the national interest.
- o Consistent with sound economics; promotes efficiency and higher incomes; contributes to a more competitive economy and helps the balance of payments; helps oil producers in California and relations with Japan and other Pacific rim countries.
- o Increases the sale price of the Elk Hills Naval Petroleum Reserve by about $100 million since higher oil prices (of up to $1 barrel) make the oil field more valuable.

CONS:

- Political resistence to the proposal in Congress is likely to be very strong.
- Could undercut the proposal to open-up ANWR, since opening up ANWR will be portrayed as putting the U.S. environment at risk to fuel the Japanese economy.
- Could lead to a total ban on the limited oil exports which are now allowed (primarily from Alaska's Cook Inlet and to Canada).

4. EMERGENCY PREPAREDNESS OPTIONS

The Administration's commitment remains firm to fill the Strategic Petroleum Reserve to 750 million barrels. The SPR presently contains 516 million barrels of crude oil acquired since 1977. The 1987 fill rate is 75,000 barrels per day and the President's budget calls for a 35,000 barrels per day fill rate in 1988. Under current projections, imports may rise to 6 to 8 MMBD in 1990 and 8 to 10 MMBD in 1995, and therefore an accelerated fill rate should be considered.

ITEM 1: Fill the SPR at 35,000 barrels per day.

- Achieves 750 million barrels in 2004.
- Provides 62 to 85 days of import protection in 1995.
- This fill rate is proposed in the current budget.

ITEM 2: Fill the SPR at 75,000 barrels per day.

- Achieves 750 million barrels by 1995.
- Provides 18% or 11-15 more days of import protection by 1995 than does the 35,000 fill rate.
- Increases outlays for SPR oil purchases by $307 million in 1988 and by $2.1 billion from 1988-1995 compared to 35,000 b/d.

ITEM 3: Increase the SPR fill rate to 100,000 barrels per day until reaching 750 million barrels.

- o Achieves 750 million barrels by 1993.
- o Achieves import protection of 83-110 days in 1993 and 74 to 99 days of imports in 1995.
- o Increases outlays for SPR oil purchases by $482 million in 1988 and by $3.3 billion during 1988-1993.

ITEM 4: Increase SPR fill rate through tax incentives.

Seek to increase the SPR fill rate through tax incentives designed to encourage the private sector to place domestic oil in the SPR. The private sector will retain title to the domestic oil, with the Federal Government having control of the types and quality of domestic oil to be stored and the conditions for its release.

Specifically, the private sector would contribute up to 75,000 b/d to SPR. The private sector would pay all transportation costs to and from all SPR terminals. The government would provide for the storage, maintainence and operation of the SPR and eligibility for two tax incentives.

In the event that the private sector does not fully respond to the stock building incentive, the Secretary of Energy would resume publicly financed purchases to assure a minimum total fill rate of 35,000 barrels per day. .

PROS:

- o Provides opportunities for private petroleum users to participate in a supply insurance program.
- o Increases SPR inventory while reducing near term budget deficit impact.
- o Would increase market efficiency by involving many parties in decisions regarding the risk of future disruption.
- o Creates a new constituency to support free market policies.

UNCLASSIFIED

CONS:

- Significant number of administrative burdens including verification of oil quanity and specifications, accounting of each participant's inventory, scheduling of deliveries consistent with leaching programs, and drawdown/distribution procedures.
- Complex logistics of providing domestic oil to existing SPR terminals, involving a potentially large number of private sector participants. The SPR was designed to be a bulk wholesaler to a continuous retailer.
- Would require major statutory changes, including minimum fill rate requirements.
- Would be viewed by some as private profiteering in the event of a severe oil supply disruption.

The effectiveness of emergency preparedness is greatly strengthened when all countries maintain adequate emergency stocks and coordinate their use. Our allies and trading partners currently hold about 350 million barrels of emergency reserves. Japan for example has committed to SPR of only 189 million barrels even though they are 100% dependent on imported oil and import over 4 MMBD. The U.S. has a SPR substantially larger than other importing countries and has had some recent modest success in getting others to increase stocks. All agencies believe the U.S. should strongly urge other countries to increase their strategic stocks, otherwise unilateral U.S. action serves as a subsidy to protect all oil consuming nations without a fair sharing of the costs.

Contribution From Other Energy Sources

The full spectrum of action needed to meet the national security concerns must, in addition to the foregoing supply and emergency preparedness options, address activities to decrease consumption of oil and gas and to recognize the displacement of oil and gas by other energy sources.

The Energy Security Study examined in detail the potential contribution from a wide variety of energy sources, including coal, nuclear, renewables and conservation. The Study shows that these sources will play a significant role in furthering U.S. energy security under present policies, and thus no additional actions appear warranted at this time.

UNCLASSIFIED

How should new initiatives be funded?

Attached is a chart which summarizes the budget impacts of the various options. Some of the options result in increased costs relative to the President's budget. Others generate increased revenues. The total net effect depends on the particular combination of options selected.

CONGRESSIONAL OUTLOOK

Moving legislation on the Hill would be affected by a number of factors. If an adequate demonstration is made that a long term energy security problem exists, there are significant elements on the Hill that would actively pursue legislation to address this problem which could lead to some form of legislation this year. The scope of such legislation is difficult to predict at this time and would depend to a significant extent on the ability of industry groups and other constituencies to make their input and views known to the Congress.

SPR/NPR Linkage

Congress consistently has required that the SPR be filled at rates greater than those proposed by the Administration. There are indications that Congress will legislate substantially higher rates in FY 1988. Similarly, there has been opposition to Administration proposals for the sale of the Naval Petroleum Reserve. We may be able to achieve our objective of selling the NPR by linking it to an expanded SPR fill rate. The estimated sale price of the NPR is $3.3 billion which would almost totally offset the highest fill rate. However, it must be noted that the sale of the NPR is already included in the FY 1988 budget.

Legislation

Twenty-eight bills have been introduced in the 100th Congress related to oil and gas issues. These range from repeal of the Fuel Use Act (FUA), to imposition of import fees on imported oil, to establishment of ceilings on crude oil and product imports.

Legislation receiving most active consideration thus far is a house bill to repeal FUA (HR 309 and companion HR 1796). Other major legislation includes:

- Energy Security Act of 1987 (S.694) introduced by Senator Bentsen (D-TX) would require the President to establish a national oil import ceiling not to exceed 50% of U.S. crude and products consumption for any given year. To prevent the ceiling from being exceeded, the President, with Congressional approval, would have authority to impose import fees, expand the SPR, and provide incentives for domestic production. The bill has bi-partisan co-sponsorship of twenty-two senators.

- The Energy Security Tax Act of 1987 (S.846), introduced by Senator Nickles (R-OK) would repeal the windfall profit tax; provide a 27.5% depletion allowance for stripper production; and eliminate the alternative minimum tax for intangible drilling costs.

- Senator Gramm is expected to re-introduce the Oil and Gas Revitalization Act of 1986, with some additional measures such as depletion allowance and tax credits.

- Representative Edwards (R-OK) has introduced legislation to increase the oil depletion allowance from the current 15% to 27.5%.

Sense of Congress Resolutions

- House resolution 16 was introduced in January by Congressman Conte (R-MA) and co-sponsored by 39 Republican and Democratic lawmakers, expressing opposition to imposition of import fees on oil and refined products.

- Senate resolution 97, introduced by Senator Pell (R-RI), opposes action by either Congress or the President to impose fees on imported crude oil or products.

Omnibus Budget Reconciliation Act of 1986

The Omnibus Budget Reconciliation Act of 1986 required the Secretary of Energy to "conduct a study of domestic crude oil production...and the effects of imports...in determining ...whether such production...is adequate to protect national security". The Energy Security report fulfilled this part of the requirement.

The Act attempts to require the President within 45 days after the report is transmitted to Congress to report his "views concerning the levels at which (oil) imports become a threat to national security and advise the Congress concerning his views of the legislative or administrative action, or both, that will be required to prevent imports...from exceeding those levels...."

Athough there is some question on the constitutional validity of this requirement, the Congress is expecting the President to report his views on energy security by May 1, 1987.